

Antitrust and Video Markets:
The Merger of Showtime and
The Movie Channel as a Case
Study

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ANTITRUST AND VIDEO MARKETS: THE MERGER OF
SHOWTIME AND THE MOVIE CHANNEL AS A CASE STUDY

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I. Introduction

Rapid advances in electronics and telecommunications technology in the past two decades have meant substantial changes in entertainment, and especially video, markets. New opportunities have arisen; new markets have been created; some firms have entered, others have exited; new business relationships have been established.

Some of these markets, especially television since its inception, have been heavily regulated by the U.S. Federal Communications Commission (FCC) (and cable television services have been heavily regulated by the FCC and by local communities). Nevertheless, antitrust has played a substantial role in affecting the structure of these markets,¹ and recent events have indicated that antitrust is likely to continue to be important.

This paper will report on one recent antitrust action that could have important consequences for these markets: the merger of Showtime and the Movie Channel, the second and third largest providers of pay programming

services for cable viewers. This merger, originally quite complex in its proposed structure, was reviewed by the Antitrust Division in 1983 and emerged in a limited form. This case study should serve as a useful vehicle for understanding the structure of and competition in video markets. It should also be useful for showing the value of the revised Merger Guidelines (U.S. Department of Justice, 1982), issued by the Antitrust Division in June 1982, for structuring and illuminating the antitrust analysis of mergers.

Section II of this paper will provide a description of the merger partners, the proposed structure of the merger, and a brief review of procedures within the Division with respect to mergers. Section III will provide the general legal and economic background for the analysis of the case, including a brief description of the Merger Guidelines. Section IV will provide a more specific analysis of the details of the merger and the antitrust problems that they appeared to raise. Section V reports the Antitrust Division's decision and its aftermath. Section VI provides some conclusions.

II. The Proposed Venture and the Antitrust Division's

Procedures

A. The Venture

As of 1982, Home Box Office (including its "sister service", Cinemax) (HBO), Showtime, and The Movie Channel (TMC) were the three leading providers of pay programming service to cable television viewers. HBO accounted for about 60% of the subscriptions to pay TV services, Showtime for about 20%, and TMC for about 10%.² HBO was (and still is) a wholly owned subsidiary of Time, Inc. Showtime was a subsidiary of Viacom International, Inc., a leading syndicator of television programs (and also the owner of a number of local cable systems). TMC was a joint venture owned equally by Warner Communications, Inc. (parent of Warner Brothers and owner of a number of local cable systems) and the American Express Company.

In November 1982, Paramount Pictures (owned by Gulf & Western), Universal Studios (owned by MCA), Warner, and American Express announced a proposed joint venture for the purpose of owning and operating TMC. The three movie studios involved in the deal accounted for 40%-50% of theatrical motion picture exhibitions in the late 1970s and early 1980s (based on gross rental fees) and are considered to be three of the six "major" studios;³ the six accounted for 80-85% of theatrical exhibitions in recent years. In January 1983, Viacom entered the picture, and the proposed venture then involved a merger of Showtime and TMC, with Paramount, Universal, Warner, American Express, and Viacom jointly owning

the merged entity. The three movie studios and Viacom would each own 22.58% of the joint venture; American Express would own 9.68%.

B. The Procedures

Under the terms of the Hart-Scott-Rodino amendments (passed in 1976) to the Clayton Act, the parties to a proposed merger or acquisition that exceeds certain size criteria⁴ are required to submit information pertinent to the merger or acquisition to the U.S. Federal Trade Commission (FTC) and to the Antitrust Division of the U.S. Department of Justice; the parties are then required to wait thirty days before consummating the deal. During this time the FTC and the Division make quick scans of the information. If either agency believes that antitrust problems may be involved, that agency asks for "clearance" from the other and begins an investigation. On or before the thirtieth day after submission of the initial information, the investigating agency can ask for more information (make a "second request") pertaining to the merger or venture; the parties must then wait another twenty days from the time they deliver this information before consummating.⁵

The intent behind the Hart-Scott-Rodino amendments was to give the FTC and the Division more time to investigate proposed mergers before their consummation and to seek preliminary injunctions from the courts for those proposed mergers that appeared to pose antitrust problems. Prior to the amendments, the agencies sometimes discovered mergers at the last minute or after the fact and had to rush into court with incomplete information and

hastily-assembled arguments; if a merger was already completed and then challenged, and the agency eventually won its case, the untangling of the merger and the re-establishment of the original entities might be difficult.⁶

The two agencies usually divide responsibility for investigations along lines of historically-developed expertise.⁷ In this case, the Division had had experience with antitrust cases in movie and video markets stretching back to the 1920s, and the Division had recently (1980) brought and won a case challenging a joint venture ("Premiere") that involved movie studios and other entities and that would have created a new pay programming service;⁸ thus, it was natural that the Division would get responsibility for investigating the Showtime-TMC proposal.

The proposed venture described above was submitted to the Antitrust Division for review in January, 1983. The procedures of H-S-R- were not formally brought into play,⁹ but the parties to the venture cooperated with the Division as if the H-S-R requirements had been in effect. The Division's investigation and decision-making processes extended over the following five months. Such extensions beyond the fifty days specified by H-S-R are frequent in complex cases. Sometimes, as was true initially in this case, the parties do not press for a quick decision. Sometimes a significant amount of time is required for the parties to provide the information demanded in the "second request". And sometimes, as the end of the second period approaches, the parties are told by the Division, "We

have not yet made up our minds as to whether we will or will not challenge this merger. With more time we may convince ourselves that the merger does not create antitrust problems or that they can be remedied. But our current doubts are sufficiently great so that if you insist on consummating at the end of the second period, we will seek a preliminary injunction to try to stop you." The parties usually prefer to wait. In this case they waited until June.

III. The General Legal and Economic Analysis

The Showtime-TMC proposal involved a somewhat complicated structure for antitrust analytical purposes. It entailed the outright merger of two providers of pay programming services (horizontal competitors), Showtime and TMC; it involved the addition of two movie studios (horizontal competitors), Universal and Paramount, to the joint venture that already involved a third studio (Warner) and controlled one programming service (TMC) and that would now control both; and the programming services were major purchasers of major theatrical films from the studios, so customer-supplier (vertical) relationships were also involved. The specific merger of Showtime and TMC clearly called for merger analysis, relevant ^{for} Section 7 _^ of the Clayton Act. The joint venture aspects of the proposal could either be treated as a type of merger, and hence also to fall under the Clayton Act, or to be considered as a "contract, combination...or conspiracy, in restraint of trade..." and hence to fall under Section 1 of the Sherman Act.

From this author's economics perspective, merger analysis seemed clearest and provided the best framework for understanding the possible competitive consequences of the proposed venture. Accordingly, the remainder of the discussion in this paper will also be in terms of merger analysis.

Section 7 of the Clayton Act instructs the FTC and the Division to challenge mergers and acquisitions, "where in any line of commerce in any

section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly." After a series of Supreme Court victories in merger cases in the 1960s, the Division issued a set of Merger Guidelines (U.S. Dept. of Justice, 1968) in 1968, attempting to provide guidance to the private antitrust bar (so that the latter could better advise their clients) as to the ways in which the Division would analyze mergers and the types of mergers the Division would be likely to challenge. In June 1982, the Division issued a revised set of Merger Guidelines (U.S. Dept. of Justice, 1982), which has served as the basis for the Division's analysis of the merger proposals that have come before it, including the Showtime-TMC proposal. Accordingly, a brief review of the revised Guidelines is worthwhile.¹⁰

Which mergers are likely "substantially to lessen competition, or to tend to create a monopoly"? In trying to answer this question, the Guidelines rely heavily on a body of thinking about seller behavior (oligopoly theory) that has been developed over the past half-century. Chamberlin (1956, chapter III) first expressed these propositions in the early 1930s, and they were later modified and extended by Fellner (1949), Bain (1956), and Stigler (1964), among others.¹¹ In essence, they argue that sellers in a market are more likely to behave in a non-competitive fashion (i.e., succeed in coordinating their actions so as to raise their prices above, or modify the quality or variety offerings from, the levels that would prevail in a more competitive industry and

hence succeed in earning profits above competitive levels) if a number of structural conditions prevail in the relevant market. Specifically, the following structural features make non-competitive behavior more likely: fewer sellers in the market; greater inequality in their relative sizes (as measured by sales shares of the relevant market--these first two conditions are usually summarized by a measure of sales concentration in the market); greater difficulty of sales expansion by existing (especially small) sellers; greater difficulty of entry into the market by entities that are not currently selling in it; a larger number of buyers (for any given volume of sales) and less concentration among them; and greater standardization and simplicity of the product being sold.¹² The Guidelines use these propositions--especially the role of seller concentration--to establish the conditions under which the Division is likely to challenge a merger as potentially or actually anti-competitive.

The application of these propositions--again, especially the role of seller concentration--presupposes the delineation of the proper market for antitrust merger analysis. If the market is not properly specified, then the market shares used for concentration measures are unlikely to be correct, entry conditions are unlikely to be correctly stated, etc., and the specific analytical conclusions may well be incorrect. Unfortunately, the economics profession has not applied much specific thought to the problem of market definition, and the general ruminations of economists on market definition, relying on the concepts of cross-elasticities of demand

and supply among related goods and services, have not been useful in providing specific guidance for antitrust purposes.¹³ It is, perhaps, in this area that the Guidelines have been most useful in furthering analytical thought on antitrust merger issues.

Noting that market boundaries must encompass both a product dimension (summarized by the Clayton Act as "in any line of commerce") and a geographic dimension ("in any section of the country"), the Guidelines indicate that a market (for merger analysis purposes) will generally be the smallest group of present or potential sellers (i.e., encompassing the smallest group of products and smallest geographic area) that, if they chose to act in a collective fashion (i.e., tried to act as a monopolist), could succeed in exercising significant market power. "Significant" is defined as the ability of this collective entity to be able profitably to raise selling prices by at least five percent (from where they currently are or could reasonably be expected otherwise to be in the future) and maintain them at that level for at least a year. In essence, a market is defined primarily on the basis of demand-side substitutability. The practical question to be asked is, "Would the demanders (of a group of products sold by a specific group of sellers located in a specified geographic area), in response to a significant price rise, switch away (to sellers of other products and/or sellers located in other geographic areas) in sufficient numbers so as to thwart the price rise in the first place?" If the answer to this question is "no", then the products sold by

those sellers from those locations constitute a market; if the answer is "yes, the price rise would be thwarted", then the tentative group is too narrow, and a wider group of sellers (in "product space" and/or geographic space) must be included and the question posed again.

The logic behind this general approach can be explained as follows: The purpose of antitrust merger analysis (and of market definition as part of it) is to detect those mergers that pose a threat to competition. If the most anti-competitive merger imaginable among a group of sellers--the combination of all of them into a single entity--could not affect prices significantly (because too many demanders would switch away in response to any attempt to exercise market power), then that group of sellers cannot constitute a market for antitrust merger analysis purposes; the relevant market must be wider.

This procedure implies that the market definition "circle" should be drawn primarily around sellers (since it is sellers who might coordinate their actions and exercise market power). A partial exception would apply to the case in which a group of sellers might not be able to raise their prices generally (because too many customers would switch away) but might be able to raise their prices successfully to a smaller group of their customers (identified by geographic area or by some other characteristic)--i.e., to practice systematic price discrimination against some smaller group of customers. In this case, the appropriate market definition would include both the group of sellers who could exercise this market power and

the group of customers who would be subject to the price discrimination.

Supply-side substitutability does not enter directly into the Guidelines' definition of a market, but it enters the Guidelines (as it must in some fashion) at two later points in the analysis. First, any firm that is not now producing the product or products in question but that could do so within six months in response to a five percent price rise without a major investment in new plant or equipment (i.e., could begin production primarily by modifying existing facilities) shall be counted as "in the market" (along with existing producers) and assigned an appropriate market share. Second, conditions of entry generally (and specifically within two years in response to a five percent price rise) are considered among the extenuating and exacerbating circumstances that could cause the Division to alter judgments drawn from market share criteria alone.

After indicating that the basis (e.g., sales revenues, physical unit sales, or production capacity) for determining market shares should be that which the sellers in the market would most likely choose as the basis for any anticompetitive coordination, the Guidelines establish "cut point" market share criteria for the likelihood of Division action on a merger. The criteria are expressed in terms of the Herfindahl-Hirschman Index (HHI), which is computed by squaring the market share of each firm in the market (e.g., if a firm's market share is 15%, the squared value would be 225) and summing all of these squared values. The HHI for a market can range from a value close to zero (if there are many firms, each with a

small market share) to 10,000 (if there is a single firm in the market).

The criteria are as follows: If the post-merger HHI is less than 1,000 (which translates empirically to roughly a four firm concentration ratio of 50), the Division is unlikely to challenge the merger. If the post-merger HHI is between 1,000 and 1,800 (which translates roughly to a four firm concentration ratio of 70) and the increase in the HHI caused by the merger (which, algebraically, must be equal to twice the product of the market shares of the merging firms) is above 100, then the Division is more likely than not to challenge the merger, depending on other conditions in the market. Finally, if the post-merger HHI is above 1,800 and the increase in the HHI caused by the merger is above 50, the Division is more likely than not to challenge the merger, and if the increase in the HHI is above 100, the Division is likely to challenge the merger.

The Guidelines then discuss extenuating and exacerbating circumstances--primarily the conditions of entry, the buyers' side of the market, the nature of the product, behavioral practices in the industry, and the antitrust history of the industry.

Next, the Guidelines discuss mergers between a seller in a market and a potential entrant into that market and between customers and suppliers (i.e., vertical mergers). The former area did not appear to be ^{an} important issue in the Showtime-TMC proposal (though, _{as is discussed below,} the movie studios could be considered as potential entrants into the programming area), but the latter clearly was. The Guidelines emphasize that a vertical merger should have

antitrust significance only if it has horizontal consequences in one or more markets--i.e., if it somehow raises barriers to entry or otherwise facilitates coordinated behavior in one or both markets.

Finally, the Guidelines address the question of the possible efficiencies that might be yielded by a proposed merger (the Guidelines state that they will be considered only in exceptional circumstances) and discuss the exceptions that might be made for mergers involving a firm that was near bankruptcy (the "failing firm doctrine", which was not an issue in the Showtime-TMC proposal).

IV. A Specific Analysis

This section will provide this author's specific analysis of the Showtime-TMC proposal. Since over a dozen attorneys and economists in the Antitrust Division were involved in the investigation and evaluation at some point, it would be improper to present this analysis as "the Division's position". In the end, it was William F. Baxter, the Assistant Attorney General for Antitrust, who made the decisions in this case, and it is only he who truly knows what specific analyses and arguments led to the specific decisions.

A. A Conceptual Framework

At the beginning, it is convenient to have a framework for understanding the roles, positions, and relationships of the major participants in the video industry. Table 1 provides a framework that this author has found particularly useful. At the top are the producer-owners of programming that eventually appears in video markets: the movie studios-distributors, the "independent" producers, and syndicators. Next are the "packagers", who usually buy (or receive licenses for) material from the first group, "package" it into a schedule of entertainment offerings, and sell (or license) the package to the third group. This last group--the cable systems, over-the-air pay stations, and local VHF and UHF television stations--distribute the programming to viewers. The distributors receive payments from viewers, from advertisers directly in return for time devoted to advertising messages, and/or from packagers (who

in turn have received payments from advertisers whose messages have been included as part of the package provided to the distributors).

These compartments are not air-tight. Many participants in the video industry extend beyond one category. The networks, for example, produce some of their own material¹⁴ and own a few local television stations.¹⁵ A syndicator may also be considered to be a packager if he tries to sell his programs directly to local stations. And a company like Warner participates in all three levels of the industry, through its movie production, its part ownership of TMC (and now Showtime), and its ownership of cable systems. Nevertheless, the schematic framework is a useful organizing device.

In the context of this framework, it is clear that the main activities of the participants in the Showtime-TMC proposal were concentrated in the first two levels of Table 1. (The ownership of cable systems by Warner and by Viacom did not seem important for the analysis.) And it was on these two levels that this author's analysis was focused.

B. Defining the Product Market

A crucial task for analysis was to determine the relevant product markets. Sales (or licensing) of programming by packagers to distributors was one important focus; the inputs into the packaging level (i.e., the sales or licensing of programming by producers to packagers) was a related, but separate, area that required market analysis. With

one could ask whether ^{was} the relevant market ^{was} comparatively narrow (pay programming services that relied primarily on theatrically-released movies), somewhat broader (all cable programming services, including free "basic" services), yet broader (all television services, including network and independent stations), or most broad (all forms of entertainment, including watching video cassettes at home, going bowling, attending sports events, going to theatrical movies, etc.). A very broad definition would have meant that the Showtime-TMC merger would have little expected competitive impact, since the merging of two packagers would involve the loss of only one entity among a large number of providers of entertainment. At the other extreme, a narrow definition would have implied that the merger would yield a significant increase in concentration among current sellers. (Whether this increase would have competitive consequences would still depend on the other structural characteristics discussed below.)

Which market definition was appropriate? In principle, there were varying degrees of substitutability among these services and activities, even extending to substitution possibilities between watching a movie on pay cable at home and going bowling. There was no strictly logical basis for choice in market definition on an a priori basis.

Fortunately, the Merger Guidelines provided, in principle, the conceptual basis (albeit, a somewhat arbitrary one) for determining the relevant market: find the smallest group sellers who, if they could

coordinate their behavior, could raise their prices by five percent and find it profitable to do so for at least a year.

On the basis of this criterion, it appeared to this author that pay programming services that relied heavily on theatrically-released motion pictures (or, as a paraphrase, "movie-driven pay services") constituted the relevant product market. All of the leading pay programming services featured and promoted heavily their showing of recently-released theatrical films. Though many of them also provided other types of programming (and hence there was some possibilities for substitution between theatrical films and other programming--a crucial point for the argument developed below), recent theatrical films appeared to be crucial to their customer appeal. Marketing studies and general industry perceptions indicated that movies were the major appeal of these services. Unfortunately, there were no econometric or other statistical studies providing estimates of or inferences as to the elasticity of demand for movie-driven pay services, which would have indicated the extent to which demanders would have diverted their purchases to other things in the event of a general price rise for movie-driven pay services. Consequently, one was left relying on impressionistic evidence, but that evidence seemed to point to the narrow definition. Even if the market had been broadened to all pay programming services, the analysis would have been little different, since the movie-driven services accounted for a very large fraction of the viewer subscriptions in this broader category. It did not appear

(impressionistically) necessary to extend the market any wider to satisfy the Merger Guidelines' test for the definition of a market.

The attorneys and experts representing the prospective Showtime-TMC owners argued (naturally) for a broader definition of the product market. They argued that viewers were interested generally in first-run, network-quality programming and did not particularly care if that programming was in the form of theatrical movies or other types of programs. They cited the fact that HBO and Showtime had recently expanded the amount of non-movie programming on their services. They also claimed that cable system owners, especially those operating older systems that offered only a comparatively small number of channels, were in a position to limit the market power of the movie-driven pay services by substituting other cable services if the prices of movie-driven services rose. But the arguments in favor of a broad market definition were also based on impressionistic evidence and lacked a statistical or econometrics base.

In the end, at least to this author, the impressionistic evidence pointed toward a narrow product market definition.

The identification of the relevant input market for packagers followed easily from this narrow definition of the packaging product market. If movie-driven pay services was the relevant market for ^{the} packagers' ^{product,} then theatrically released films was the relevant input market. (The two following sections will concentrate largely on the movie-driven pay services market; further discussion of the input market will be delayed

until sections E-G.)

C. Defining the Geographic Market

The definition of the geographic market was less difficult. All of the leading movie-driven pay services distributed their programs nationwide via satellite. Regional location did not seem to matter. Hence, any effort to exercise market power would have to include the nationwide group of firms. Further, though a group of packagers in principle might have been able to raise prices selectively to one region or even to one cable operator, this type of systematic price discrimination did not appear to be likely in practice. All packagers quoted prices to cable operators from standard "rate cards". Special deals (i.e., unsystematic price discrimination) with some cable operators might be possible, but systematic price discrimination seemed unlikely. And even if it could take place, the market share, entry, and vertical arguments made below would still apply in roughly the same way.

Accordingly, a national market seemed appropriate for movie driven pay services. (Similar arguments pointed toward a national market for the crucial input, theatrically-released films.)

D. Determining Appropriate Market Shares

The subscriber market shares, as of the end of 1982, indicated that HBO accounted for approximately 60% of the market, Showtime had about 20%, and TMC had about 10%, with the remainder divided among a few other

services. These data indicated that the relevant market was quite concentrated (with an HHI of about 4,000) and that the merger would increase concentration substantially (the change in the HHI would be about 400).

The attorneys and experts for the joint venturers argued that these market shares vastly overstated the true abilities of these firms to exercise market power. Since virtually all programming services (packagers) did (or would soon) distribute their programs via nation-wide satellite systems, they could expand their sales easily; there were no physical production problems. They only had to convince more cable viewers to subscribe to their service in cases where the cable system offered it, convince more cable systems to offer the service, and/or convince more homeowners to subscribe to cable (and to their particular service) in communities where it was offered. And (according to this argument), since viewer preferences for any given programming service (or even to movie-driven pay services generally) were not strong, these expansions could take place easily in response to any effort by the movie-driven pay services to raise their prices. Hence, one ought to consider each packager (regardless of current market shares) as having a more-or-less equal capability to attract viewers. Further, there were at least forty or fifty programming services (some pay, some free) in existence and new ones being announced frequently. Accordingly, concentration in this market was quite low, and the merger of Showtime and TMC would not impair

competition.

Again, there was no hard evidence to support these assertions. These arguments downplayed the significance of any brand-name reputation or recognition among packagers. And they denied the existence of a relevant market consisting of movie-driven pay services. To this author, in any event, they did not appear convincing.

E. Entry

Even if one was not convinced by the claims of easy substitution discussed in the previous paragraphs, there was a more limited question that could be asked: With the relevant market limited to movie-driven pay services, how difficult was entry into that market? And here the answer appeared to be "not overwhelming". In principle, it appeared possible for current packagers (either of other pay services or of free services) or for de novo entrants to become a movie-driven pay service. They would simply have to obtain the licenses for a package of films from one or more movie distributors and then convince cable operators to offer their service. The entrant might encounter brand-name recognition problems; HBO, especially, appeared to have strong brand-name recognition. But adequate advertising, a good selection of films, and (perhaps) a good brand name in other aspects of the entertainment business (as, for example, the movie studios might bring to this area if they chose to enter it) could probably overcome these difficulties.

Indeed, at the time of the investigation, one firm (Disney) had recently expanded into movie-driven pay services, another (headed by Rupert Murdoch) had announced plans for a direct broadcasting (over the air) service that would feature movies, and a small movie-driven pay service ("Spotlight", owned by five cable operators and offered, at the time, only to their subscribers) had earlier announced plans to "roll out" their service to a national audience. (The Spotlight owners, however, suspended their expansion plans after the Showtime-TMC proposal was announced.)

The experts for the joint venturers argued that entry was quite easy. It is worth noting, though, that this argument conflicted with the arguments made by the executives of the three movie studios involved in the Showtime-TMC proposal. This latter group felt that HBO had been exercising market power--monopsony power--in its purchases of films and hence had been paying prices for films that were too low. Thus, in addition to any direct efficiencies that might be gained through the joint venture, they saw the venture as providing an opportunity to offset (to some extent) HBO's market power. (The same three studios, plus Twentieth Century Fox, had been joint venturers in the earlier effort, Premiere, that the Division had successfully challenged in court in 1980; their arguments in support of Premiere had also involved claims of offsetting of HBO's monopsony power.) Monopsony power by HBO and easy entry into movie-driven pay services were logically incompatible.

In any event, to this author the question (of whether entry into

movie-driven pay services was easy enough to provide an adequate check on the exercise of market power) was a close one. Entry was surely not as easy as the joint venturers' experts claimed, but recent experience and the simple technology of entry indicated that it could not be impossibly difficult either. In the end, if the supply of theatrically-released films were adequate (as will be explained below), it appeared that entry would probably be a sufficient check of the exercise of market power (on either the buying or selling side). Thus, opposition to the simple merger of Showtime and TMC did not seem warranted.

But the proposal before the Division was not limited to this simple merger. The proposal also involved the inclusion of Universal and Paramount, joining Warner, as co-owners of the joint venture controlling Showtime-TMC. And it was this strengthened vertical link between the movie studios and the merged packagers that posed more serious competitive problems.

F. Simple Collusion Upstream?

At first glance, it might seem that just the joining of the three movie studios in a joint venture might by itself give rise to added opportunities for coordinated, anti-competitive behavior in the pricing of movies to pay programming services. But the structure of the joint venture was too loose to provide much support for this notion. The studios were not required to provide any or all of their films to the joint venture, nor was exclusivity (the practice of promising that only one programming

service would have the right to show a given film, at least for a limited period of time) required for any films provided to the joint venture or forbidden to the studios in their dealings with other packagers. The joint venture might provide studio executives with an extra forum for coordination of their activities, but the industry (like virtually all other industries) already had many other opportunities for coordination (such as industry association meetings and conventions, the conventions of supplier and customer groups, joint ventures for activities outside the U.S., etc.) if they were so inclined. One extra forum did not appear to be important.

Further, even if they did coordinate their behavior among themselves, the three studios together might not be able to exercise market power. That ability would rest on the nature of the demand for the output of the three together and the nature of the supply response by the rest of the industry.¹⁶ As elsewhere, there were no data that could shed light on this question. The answer was far from clear. This author was prepared to accept the proposition, at least for the purposes of argument, that the three studios together could not exercise market power.

G. The Vertical Link

The Showtime-TMC proposal envisaged a joint venture in which three movie studios, accounting for 40%-50% of theatrical rentals (and about the same percentage of license revenues to pay programming services), would own (along with Viacom and American Express) a major packager (Showtime-TMC)

accounting for about 30% of the relevant downstream market and using movies as a crucial input to its service. Thus, the joint venture created a major vertical (customer-supplier) link between these two groups of producers. Was there potential competitive harm that could develop from this vertical link, and how could it arise?

Unfortunately, much traditional legal thinking (and some economic thinking) on vertical relationships has not been productive. In the merger area, specifically, theories of "foreclosure" and of "leverage" have been developed that (too simplistically) argue that vertical mergers will allow a firm (or firms) with market power in one market to enhance its market power (and profits), more-or-less automatically, through expansion into the second, vertically-related market.¹⁷ Unfortunately, the means by which this enhancement occurs is frequently not specified. And, for the simplest case--that in which the customer (downstream) industry uses the input from the supplier (upstream) industry in fixed proportions with the other inputs it buys from other sources--the ^{leverage} argument is simply wrong. With fixed proportions, a monopolist in the upstream industry, facing a competitive downstream industry, can fully capture all of the potential monopoly profits inherent in the final product by charging the appropriate wholesale price to the downstream competitors. The upstream monopolist cannot gain more by integrating into (and monopolizing) the downstream industry.¹⁸

Thus, even if one believed that the three movie studio joint venturers could exercise market power individually or jointly, if one also believed

that the downstream packagers used movies in roughly fixed proportions with other inputs, then the joint venture could not enhance their market power and could not be anticompetitive on those grounds.

If fixed proportions in the use of inputs downstream does not hold--if some substitutability among inputs is possible--the case becomes more complicated. The downstream firms, in response to the high (monopoly) price charged by the upstream monopolist, will try to substitute away from the over-priced input toward other inputs. This substitution causes a reduction in sales and profits for the monopolist and causes him to maintain a price lower than it would be in the absence of substitution. The substitution also represents a social inefficiency, since the substitution takes place only because of the high monopoly price; if competitive prices were charged for this input, the substitution would not take place.

In these circumstances, the upstream monopolist can enhance his control over the downstream market by integrating into and monopolizing it. In so doing, he prevents the inefficient substitution, and this capture of the improvement in efficiency becomes one source of increased profits for him. Further, his elimination of the substitution possibilities also enhances his monopoly power over the sales of his upstream product, providing another source of increased profits. After integration, social efficiency (including both the improved production efficiency downstream and any change in allocative efficiency from the enhanced monopoly power,

but ignoring any direct transfer of profits from demanders of the downstream product to the monopolist as a pure transfer) may increase or decrease. If the downstream product price decreases as a consequence of integration, social welfare surely improves; if the downstream price increases, the social welfare change can go in either direction. In any event, the outcome is theoretically indeterminate, depending on a crucial set of empirical parameters (such as the elasticity of substitution among the inputs and the elasticity of demand for the downstream product).¹⁹

Did this more complicated scenario provide a good fit to the proposed joint venture? The downstream packagers were able to do some substituting of other programming inputs for movies, as the recent experience of HBO and Showtime had indicated. But the three movie studio joint venturers, by themselves or jointly, arguably could not exercise market power. Further, it was not clear how they could achieve the monopolization of the downstream market solely through the ownership of a firm accounting for only 30% of the downstream market. And, finally, even if the two previous conditions were met, the social efficiency consequences, and even the direction of the price change that might face cable operators and viewers, of a possibly monopolizing vertical merger of this kind could not be predicted. This complicated scenario did not appear to this author to provide a solid basis for deciding that the joint venture was anti-competitive.

Instead, a more novel theory, partially encompassing the complicated

substitution scenario from above and partially encompassing the "raising-costs-to-rivals" theory of Salop and Scheffman (1983), provided a better basis for fears that the joint venture could be anti-competitive.²⁰ This new theory was consistent with the Merger Guidelines' admonition that the anti-competitive effect of a vertical merger should occur through enhanced opportunities for horizontal coordinated behavior.

The theory requires a number of circumstances to be present. First, there needs to be some possibilities for substitution of inputs by the downstream industry.²¹ Second, the downstream merger partner should be a sizable (but not necessarily dominant) entity in its market (or a small firm that could readily expand its market share); but neither high concentration nor difficulty of entry downstream need be present. Third, the upstream industry should be at least moderately concentrated, with moderate-to-high barriers to entry, so that increased market power (i.e., increased coordinated behavior) among the upstream firms is a realistic possibility. And, fourth, the upstream merger partner should be a sizable (but not necessarily dominant) entity in its market.

Under these circumstances, a vertical merger could well be anti-competitive. The merged (integrated) entity would have an increased incentive to seek coordinated behavior among its upstream rivals that would raise prices to the downstream industry. The increased incentive arises because the downstream integrated entity does not have to buy its input at the high (non-competitive) price that results from the upstream coordinated

behavior but instead buys from its upstream partner at the true opportunity cost of the input. It thus avoids the higher costs that its downstream rivals experience as a consequence of the higher price of the input (and it avoids any inefficiency of substitution that the higher upstream price might induce). In essence, the integrated entity remains efficient and makes extra profits at the expense of its downstream rivals, whose costs have been raised.²² The profits of the integrated entity are greater than those that the upstream entity alone would earn from the coordinated behavior in the upstream market. (Whether the integrated entity records the higher profits as accruing at the upstream or downstream level is purely an accounting technicality; the incentives of the integrated entity are unaffected.)

Note that, unlike either the simple or the complicated foreclosure theories, this scenario does not require that the upstream entity have market power at the time of the merger nor that coordinated behavior is occurring generally in the upstream industry at the time of the merger. Instead, it points to the heightened incentive of the integrated entity to engage in coordinated behavior upstream and hence the increased likelihood of coordinated behavior upstream, as a consequence of the vertical merger. It is true that profit-seeking firms always have an incentive to seek coordinated behavior with their rivals, so as to enhance their joint profits. This is the essence of modern oligopoly theory that, as was mentioned in Section III, stands at the heart of the Merger Guidelines.

But there are always risks to a firm's efforts to induce coordinated behavior by its rivals. The rivals may miss the signals provided by the initiating firm, or they may deliberately "cheat" on or "double-cross" the initiator. Further, these efforts may encourage entry that had not been expected. Or they may attract antitrust attention. Consequently, in this risks-and-benefits situation, a firm will engage in efforts to induce coordination only to a level at which marginal costs equal marginal benefits. The vertical merger should increase marginal benefits and thus induce more efforts at achieving coordinated behavior upstream.

How well did the Showtime-TMC proposal fit this yet-more-complicated scenario? First, downstream substitutability was a possibility. Second, the downstream partner (the merged Showtime-TMC) accounted for 30% of the downstream market; it was definitely a sizable entity. Third, the upstream market was moderately concentrated, with sizable barriers to entry. Though film production appeared to be competitive (with easy entry), film distribution was the bottleneck. As was noted above, the six major studios accounted for 80-85% of theatrical rentals in the late 1970s and early 1980s. No new major distributors have arisen since the end of the Second World War to challenge the position of the existing majors.²³ Finally, the upstream entities (Paramount, Universal, and Warner) were, collectively, a sizable entity, accounting for 40%-50% of theatrical rentals.

Accordingly, the circumstances of the joint venture appeared to fit the model quite well. Further, at the time that the Division was

evaluating the Showtime-TMC proposal, HBO had an exclusive distribution agreement with Columbia Pictures; and HBO, Columbia, and CBS had proposed a joint venture ("Tristar", which the Division was also evaluating) to create a new production and distribution entity.²⁴ Though there are pro-efficiency arguments to support exclusive distribution arrangements (they encourage greater downstream advertising and other enhancement of the product), they may also achieve through long-term contracts many of the same outcomes achieved through vertical merger. Thus, it appeared that if the Division approved both the Showtime-TMC joint venture and the HBO-Columbia-CBS joint venture, four of the six major studios would be tied to the two major packagers in some fashion, and the incentives for upstream coordinated behavior would be yet greater.

The attorneys and experts for the Showtime-TMC joint venture argued that the provisions of the joint venture greatly reduced the likelihood that coordinated behavior upstream would occur. First, the management of the joint venture was insulated, to some extent, from the managements of the movie studios. Second, the upstream studios were not required to bring their films to the joint venture. Thus (it was claimed), they would still have strong incentives to compete actively and would be unlikely to induce or engage in coordinated behavior. Third, in some cases the studios did not own the pay-cable rights to the films that they had theatrically distributed, or key figures in the production of those films had negotiated special pay-cable profit shares for themselves; thus, the studios' ability

to exert market power in the sale of films to the pay-cable (packager) market was not as great as their theatrical market shares indicated.

Fourth, suppose the movie studios tried to coordinate their behavior by withholding films from other packagers and providing them only to the joint venture, thereby earning extra profits through the higher prices that Showtime-TMC could charge. But the studios each had fixed ownership and profit shares in the joint venture, which thereby provided each with an incentive to "free ride" and let the others withhold from the packagers and provide to the joint venture, while it tried to sell to the other packagers. This free riding would cause any coordinated efforts to raise price to unravel. Fifth, if the coordinated behavior took the form of simply raising the price of films, the additional profits would be earned upstream, by the movie studio joint venturers, at the expense of the downstream joint venture itself. Hence, Viacom and American Express, the other joint venturers, would be hurt by any such behavior and would surely complain and try to thwart these efforts.

These arguments were not convincing. So long as the three movie studios ultimately controlled the joint venture (through their majority ownership) and profited from its actions, their incentives to induce coordinated behavior among all upstream industry participants were clear.²⁵ No management structuring could prevent this incentive from arising, and any free-riding possibilities could only offset this basic incentive for coordinated behavior to a limited extent. Further, other pay-cable profit

participants would be the beneficiaries of coordinated behavior by the studios and would be unlikely to thwart that behavior; and the bottleneck position of the studios in theatrical distribution, where the primary value for pay-cable distribution was created, ensured that the studios would ultimately be able to extract (from the other participants) the gains from coordinated behavior. Finally, Viacom and American Express could quite possibly be mollified through side payments, special purchases, or "creative accounting" within the joint venture; if there were extra profits to be made, the studios could find some way of sharing some of them with the other joint venturers so as to keep them contented. ¹²

In sum, this complicated model of the vertical link created by the joint venture appeared, to this author, to provide a reasonable basis for fearing that the venture could have an anti-competitive impact and hence would constitute a violation of the Clayton Act.

V. The Outcome

In June 1983, after a series of meetings with the representatives of the joint venturers, the Antitrust Division decided that the joint venture, in the form it had been proposed, raised potential anti-competitive problems. The Division informed the parties that they would be challenged in court if they tried to consummate the arrangement.²⁷

A few weeks later the joint venturers returned to the Division with a set of proposals (a possible consent decree) that would have limited the joint venturers' behavior and possibly reduced the possibilities for coordinated behavior. After a few days' consideration, the Division rejected the modified proposal. So long as Paramount and Universal were part of the proposal,²⁸ the inherent structure of the joint venture provided unavoidable incentives for upstream coordination that behavioral restrictions could never erase. Further, the Division was generally reluctant to enter into consent decrees that involved an extensive amount of "regulatory" supervision of an industry's behavior, which the proposal would now require.

In August, the parties proposed a simple merger of Showtime and TMC, keeping Warner, Viacom, and American Express as the joint venturers but excluding Paramount and Universal. The Division indicated that it would not challenge the merger.

In December the cable system owners of Spotlight decided to abandon

their plans to expand the service and instead sold it to Showtime-TMC. And also in December, Paramount entered into a five year exclusive distribution arrangement with Showtime-TMC.

VI. Conclusion

The Antitrust Division's treatment of the Showtime-TMC proposal provides a good example of the fruitful use of the Division's revised Merger Guidelines. It also demonstrates a solid reason for being suspicious of vertical mergers in situations in which the upstream industry is at least moderately concentrated and entry is not easy. The possible efficiency gains from such mergers should not be neglected (at least in economics, if not in law), but neither should the possibilities of heightened incentives for anti-competitive conduct upstream.

In this author's view, the Division's decisions in this case, though not easy, were correct. It would have been useful to have had more information on which the decisions could have been based. But, in the time periods usually available for investigation and evaluation, complete information (however defined) is rarely available. In light of the limited information that was available, the decision appeared sensible.

The aftermath, though, raises one disquieting possibility. Paramount has entered a five year exclusive distribution arrangement with Showtime-TMC. Will other studios follow? Will the movie studios achieve through long-term contracts what they failed to achieve through more direct means? Again, there are pro-efficiency reasons for exclusive distribution arrangements in this industry, but they can also create the same incentives for coordinated behavior upstream as do vertical mergers. In the absence of any knowledge of the details of the Paramount arrangement, this author

should (and will) remain agnostic. But continued antitrust vigilance in these markets does appear to be warranted.

Table 1: Schematic Representation of the Video Industry

<u>General Category of Activity</u>	<u>General Types of Participants</u>
Programming producers-owners	Movie studios-distributors Producers for television Syndicators
Programming packagers	Pay television programmers "Basic" services programmers Television networks "Super stations"
Distributors of programming to viewers	Cable systems Over-the-air pay channels Local VHF and UHF television stations

Notes

* Much of the information and analyses contained in this paper were generated while the author was the Director of the Economic Policy Office in the Antitrust Division of the U.S. Department of Justice. Many economists and attorneys in the Division contributed to the information and analytical insights that were developed as part of the investigation and evaluation of this case, including Bruce K. Snapp, I. Curtis Jernigan, Margo B. Faier, Timothy J. Brennan, and Sheldon Kimmel among the economists; and William F. Baxter, Wayne D. Collins, Stanley M. Gorinson, Robert E. Hauberg Jr., Seymour H. Dussman, Gordon G. Stoner, Monica R.H. Roye, David Schertler, Mark P. Leddy, and Neil E. Roberts among the attorneys. Thanks also are due to Steven C. Salop for helpful suggestions. The contents of this paper, however, are solely the responsibility of the author and do not necessarily reflect the views of the above named individuals or of the U.S. Department of Justice.

1. The "Paramount decrees" substantially altered the structure of the motion picture business. See U.S. vs. Paramount Pictures, 334 U.S. 131 (1948). In television, consent decrees limiting the three networks' abilities to produce and own programming were entered in 1977 and 1980. And in 1980 the U.S. Department of Justice successfully challenged a joint venture ("Premiere") that involved four movie studios and other entities and that would have established a new programming service for cable viewers. See U.S. vs. Columbia Pictures, 507 F. Supp. 412 (1980) and 659

F. 2nd 1063 (1981).

2. These figures can be derived from data found in various issues of CableVision.

3. Twentieth Century Fox, Columbia Pictures, and MGM-United Artists are considered the other major studios; Orion and Disney are considered to be second tier, or "mini-majors". The share figures can be derived from data found in various issues of Variety.

4. The acquiring firm must have total assets or annual sales of at least \$100 million; the acquired firm must have assets or sales of ^{at least} \$10 million; and the acquiring company must acquire at least \$15 million in assets or 15% of the voting securities of the acquired company.

5. If the transaction involves a tender offer, the time periods are reduced from 30 and 20 days to 15 and 10 days, respectively. Also, consummation can occur earlier if the investigating agency indicates that it will not challenge the merger.

6. A common antitrust expression in the merger area is that "it is difficult to unscramble the eggs".

7. For example, cases involving companies in the petroleum and food manufacturing industries are usually taken by the FTC; cases involving companies in the steel industry and in regulated industries are usually taken by the Division.

8. See U.S. vs. Columbia Pictures, 507 F. Supp. 412 (1980) and 659

F. 2nd 1063 (1981).

9. The reasons for the absence of formal H-S-R procedures in this case are not entirely clear to this author; apparently, under some circumstances, H-S-R does not apply to joint ventures.

10. For a further discussion of the Guidelines, see Fox (1982), Symposium (1983), and Werden (1983).

11. The Guidelines also acknowledge the "dominant firm" model developed by Landes and Posner (1981), but the main theory underlying the Guidelines is that of a group of oligopolists coordinating their actions.

12. Other factors encouraging oligopolistic coordination can be found in Scherer (1980, chapters 5-8).

13. See Stigler (1982, p. 9) and Scherer (1980, pp. 60-61).

14. They are restricted in this respect by the Division's consent decrees of 1977 and 1980.

15. They are restricted in this respect by FCC regulations.

16. See Landes and Posner (1981) and Reynolds and Snapp (1982).

17. See Posner (1976, pp. 197-201), Bork (1978, pp. 229-238) and Kaserman (1978).

18. See Westfield (1981) and McGee and Bassett (1976).

19. See Westfield (1981).

20. This theory was suggested to the author by Steven Salop.

21. The possibilities of substitution of inputs needs to be present, at least, for the downstream merger partner; it need not be present for the rivals of the downstream partner.

22. The extra profits could occur purely from the higher input costs that the downstream merger partner avoids but that its downstream rivals face. To the extent that its lower costs allow the downstream partner to expand at its rivals' expense, yet higher profits will be gained. In this latter (and probably more general case), the disadvantaged position of the other downstream firms would decrease the profitability of, and hence incentives for, upstream coordination by the other upstream firms. But the total profits from coordinated behavior by the upstream firms (including the integrated entity) should be higher than in the absence of any vertical integration, because of the added efficiency (and hence profitability) created by the integration in the presence of upstream coordination. Hence, the overall incentives for upstream coordination should still increase.

23. See Waterman (1979). The source of the barriers is unclear; it may be in economies of scale in risk absorption (since each movie is a costly and highly uncertain venture) or in maintaining a nation-wide network of sales offices and representatives.

24. The Division subsequently approved the HBO-Columbia-CBS joint

venture.

25. See Reynolds and Snapp (1982).

26. Also, if Viacom and American Express were unhappy with their position, they might sell their ownership interests to the studios; it would then be an interesting question as to whether the Division could or would sue the parties concerning this sale.

27. The Division issued a press release to this effect shortly after it informed the parties; the Division also issued press releases after it informed the parties of its subsequent decisions.

28. The logic of the argument developed in Section IV indicates that even Warner's presence alone in the venture could have an anticompetitive effect. But Warner had the advantage of already being a co-owner of TMC. And the possible anticompetitive effect from Warner alone seemed, to this author, to be much less serious than the effect from the joint presence of the three studios.

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